

STATEMENT

OF

GARRETT E. BROWN, JR.  
ACTING DEPUTY MARITIME ADMINISTRATOR

ON

BEHALF OF

THE

DEPARTMENT OF TRANSPORTATION

BEFORE THE

SUBCOMMITTEE ON MERCHANT MARINE  
MERCHANT MARINE AND FISHERIES COMMITTEE  
U.S. HOUSE OF REPRESENTATIVES

ON

FEDERAL SHIP FINANCING ASSISTANCE UNDER  
TITLE XI OF THE MERCHANT MARINE ACT, 1936

JUNE 25, 1985

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ADMINISTRATOR, DEPARTMENT OF TRANSPORTATION, BEFORE THE  
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June 25, 1985

Mr. Chairman and Members of the Subcommittee on Merchant Marine. My name is Garrett E. Brown, Jr., and I am the Acting Deputy Maritime Administrator of the Maritime Administration. I am accompanied this morning by Mr. Richard E. Bowman, Acting Deputy Maritime Administrator for Inland Waterways and Great Lakes.

I appreciate the opportunity to appear at this oversight hearing on the Federal Ship Financing Program that is administered by the Maritime Administration of the Department of Transportation, under Title XI of the Merchant Marine Act, 1936.

Background

The Federal Ship Financing Program (Title XI Program), was enacted in 1938, as an amendment to the Merchant Marine Act, 1936, in order to provide a supplemental method of financing ship construction. The Federal ship mortgage insurance provided by that amendment was to extend Federal aid to our domestic merchant marine by attracting the investment of private capital for financing the construction of U.S.-flag shipping. The scarcity of private investment capital was cited as contributing to the obsolescence of our domestic fleet. The fleet was in urgent need of modernization and expansion for reasons of national defense as well as safety. Subsequent amendments were made through the 1960's as the Title XI

Program was modified to accommodate the requirements of the U.S.-flag merchant marine, both foreign and domestic.

Of particular note is legislation enacted during the 1970's that had a significant impact on the Title XI Program. The first was the Merchant Marine Act of 1970 which, among other things, through various provisions, promoted the construction and maintenance of U.S.-flag bulkers. Additionally, pursuant to that Act, the Capital Construction Fund (CCF) was made available for Great Lakes vessels, in order to foster the construction of these vessels in the United States.

Another significant statute enacted during the period was the Federal Ship Financing Act of 1972. Prior to 1972, Title XI was an insurance program providing insurance for the payment of the outstanding balance of a mortgage after default. Due to the limited acceptance of the Title XI obligations by the investment community, the Federal Ship Financing Act of 1972 was enacted to improve the program and attract more private debt capital for vessel construction by making the obligations more marketable. Under this legislation, rather than insuring a loan or mortgage agreement from an institutional investor, the full faith and credit of the United States now directly guarantees the payment of principal and interest on obligations which are sold to individual bondholders. This improved the marketability of Title XI guaranteed obligations.

Pursuant to this statutory framework, the Title XI Program guarantees commercial loans to finance domestic vessel construction. The program does not itself extend loans or subsidies to shipowners or shipbuilders. It enables owners of eligible vessels to obtain access to long-term, fixed rate financing from private capital markets, at interest rates comparable to those obtained by AAA-rated corporations.

The Government guarantees prompt repayment of obligations issued by the shipowner in private capital markets. The Government's guarantee is secured by a first preferred mortgage on the vessel and by certain stringent conditions on the vessel owner. At the present time, the amount guaranteed cannot, by regulation, exceed 75 percent of the actual vessel cost. Title XI ship mortgage guarantees are available for a maximum period of up to 25 years from the vessels's date of delivery, but periods are reduced to be consistent with the expected economic and operating lives of the guaranteed vessels. Most Title XI mortgages cover a period of approximately 20 years. Short-term guarantees of interim financing during the ship's construction period are also available.

The Program is designed to be self-supporting and user fees and interest on investments have funded almost all program costs to date. Applicants for Title XI are charged a one-time investigation fee, plus an annual guarantee fee.

Each approved Title XI applicant is required to enter into certain agreements which establish continuing financial covenants and require reserve fund deposits that are contributed from earnings. These agreements limit the business and financial activities of the company so as to help preclude, though not remove, the possibility of adverse business transactions and the dissipation of funds from the Title XI company. The reserve fund deposits, which approximate 50 percent of the project's net cash flow and are held by an independent depository, provide a source of funding to meet ongoing expenses when market or other conditions prevent profitable operations of the vessel.

Despite these reserve requirements, many projects are faced with potential failure when economic and financial conditions deteriorate. If it is anticipated that economic and financial problems will improve within the short-run (two years or less), the Maritime Administration has the authority to advance funds to the shipowner to help overcome short-term difficulties. Advances have been made almost exclusively for debt service, with a limited number used for insurance payments to protect the government collateral. In a few situations, it has been possible for the agency to assume the debt of the shipowner. This alternative is only pursued, with bondholder consent, when it can be clearly demonstrated that it is advantageous to the government's collateral position.

Program Reform

On March 13, 1985, the Department announced a series of reforms and improved criteria for Federal guarantees of private sector financing for the construction or reconstruction of vessels in U.S. shipyards. These new regulations were designed to more specifically define the guidelines for issuing and administering Title XI Guarantees and to assist both applicants and the Department in preparing and evaluating applications in the most efficient, cost-effective, and equitable manner possible.

The provisions of these new Title XI regulations include the following:

1. Require a more detailed assessment of the economic viability of the Title XI applicant's project, and the projected net demand for new vessels in the trade in which the vessels will operate;
2. Require an applicant to demonstrate that the Title XI project will generate at least a 10 percent internal rate of return;
3. Strengthen the financial criteria that applicants must meet, including increased levels of equity investment;
4. Codify and tighten requirements that must be met by financially troubled companies which seek financial assistance from the government to service Title XI debt. Specifically, the regulations clearly define the financial conditions, collateral value and repayment that must exist for any advance to be granted; and

5. Increase the applicant's Title XI investigation (application) fees from the previous one-eighth of 1 percent to one-half of 1 percent of guaranteed amounts up to and including \$10 million. Any guaranteed amount exceeding \$10 million will carry a fee of one-eighth of 1 percent.

#### Growth of the Title XI Program

The Title XI Program has developed rapidly. Historically it has played a central role in the expansion and modernization of the U.S. merchant fleet. The program has guaranteed, since its inception, more than 7,000 vessels worth over \$14 billion at the time of construction. In addition to the construction benefits of the program, the operation of Title XI financed vessels generate continuing revenues and jobs in the U.S. economy. During the 1960's, the Maritime Administration financed two basic types of projects: subsidized liner vessels and tankers primarily intended for the protected domestic trade. During the 1970's, several economic factors, primarily the United States desire to be energy-independent, led to significant Title XI assistance for the construction of LNG vessels, domestic tankers, drill rigs and support equipment. In addition, during this period, a significant increase in the export of agricultural products created an increase in demand for the Title XI construction of inland tugs and barges.

Orders for 16 LNG tankers utilizing Title XI financing with owners' costs in excess of \$1.5 billion were placed with American shipyards in the mid 1970's. The discovery of oil at Prudhoe Bay and the subsequent construction of the Alaska Pipeline was a prime

factor in the ordering of 62 tankers which were financed under the Title XI Program during the 1970's. The dramatic increases in oil prices by OPEC in 1973 and again in 1978 led to a renewed commitment to develop domestic offshore reserves and resulted in large new orders for drilling rigs and support vessels, some of which were financed under the Title XI Program. As a result of this commitment to be energy-independent, as well as the substantial increase in construction costs due to inflation during the 1970's, the Title XI Program experienced tremendous growth. It should be noted that this growth was the result of vessel construction to meet anticipated energy demands and was not caused by any change in the law that permitted Title XI financing for a broader spectrum of vessels. At the end of FY 1970, the program's portfolio was under \$1 billion, rising to \$7 billion by the end of FY 1980, and peaking at slightly in excess of \$8 billion by the end of FY 1982. As of June 25, 1985, the outstanding guarantees and commitments totalled approximately \$6.9 billion. Attached as Appendix A to my prepared statement is a breakdown of the type of vessels and outstanding Title XI guarantees and commitments as of June 25, 1985.

#### The Federal Ship Financing Fund

I would now like to discuss the Federal Ship Financing Fund (Fund) that is used to pay all of the operating costs associated with the Title XI Program. The Fund is made up of the investigation and guarantee fees that I mentioned, plus interest income and sale proceeds from defaulted equipment.



The Fund was initially allocated a corpus of \$1 million. Due to the small number of projects financed under Title XI during the 1950's, the size of the Fund remained very small. Consequently, borrowings from the Treasury were necessary on four occasions following Title XI defaults in the late 1950's and early 1960's. A total of \$18.3 million was borrowed between 1958 and 1966. As the Title XI program continued to expand, the Fund generated sufficient revenues to fully repay these borrowings by the end of 1968.

Thereafter, the Title XI Program experienced no significant defaults until the bankruptcy and default of Pacific Far East Lines, Inc. (PFEL), a major U.S. West Coast liner operator, in 1978 which resulted in a Title XI payment of approximately \$105 million. However, the net loss to the Title XI Program was approximately \$34 million after the disposition of the mortgaged vessels. The payoff of the PFEL guaranteed debt did not require a borrowing from Treasury. At that point, including PFEL, there has been a total of 13 Title XI defaults with a gross loss of \$148 million. Of this amount, \$99.3 million was recovered through the disposition of assets, for a net loss of \$48.7 million.

As with all lenders doing business with maritime interests, the effect on the Title XI program of the continued worldwide slump currently affecting all segments of the maritime industry has been an increase in the inability of shipowners to make their scheduled debt payments. This has, in the past few years, resulted in a greater number of defaults under the Title XI Program than at any

time in the program's history. In Fiscal Year 1983, \$91.2 million was paid off in guarantees, relating to 10 Title XI defaults. In fiscal year 1984, there were an additional nine defaults under the program, for which guarantees totaling \$101.3 million were paid-off. Thus far in fiscal year 1985, there have been 11 defaults, requiring pay-offs of approximately \$192.3 million.

The greatest number of defaults over the past three years have been concentrated in those segments of the maritime industry hardest hit by the prolonged downturn -- inland equipment and support vessels servicing the offshore drilling industry. In these segments, utilization rates and day rates have fallen below the levels which must be attained in order for operators to service their capital costs, especially those with equipment financed in recent years when unusually high interest rates were prevailing.

Mr. Chairman, this situation and the current bankruptcy law have placed real strains on the Title XI Program. As you know, prior to the Bankruptcy Reform Act of 1978 (Public Law 95-598), when there was a Title XI default by a shipowner in bankruptcy, the Bankruptcy Court was prohibited by a specific provision of law from enjoining the Secretary from foreclosing on the vessel mortgage if the Secretary determined that such a foreclosure was in the best interest of the Government. The Bankruptcy Reform Act of 1978 did not retain the Secretary's immunity from an injunction or the automatic stay provisions of the Bankruptcy Code. As a result, the Secretary of Transportation, as a Title XI mortgagee, has been

subject to the automatic stay provisions of the Bankruptcy Code and prohibited from taking timely unilateral foreclosure action on a Title XI mortgage. The Secretary is no longer able to recover losses in a bankruptcy situation within a relatively short time period, but must go through lengthy bankruptcy proceedings. Many of the shipowners who defaulted on their Title XI obligations in the past few years have filed for protection under Chapter 11 of the Bankruptcy Code. Thus, the Secretary does not have the ability to protect the Government's financial interest by realizing the collateral value of the vessels, even though substantial funds were paid on the Title XI guarantees.

Currently, the Department is unable to sell vessels for which \$144.2 million in Title XI debt has defaulted because these vessels are under the protection of the Bankruptcy Court.

Almost all of these vessels are being operated by their owners under the protection of the bankruptcy courts. Since these vessels are being operated in many cases with little or no capital cost to cover, they are causing significant injury to those operators who continue to honor their financial commitments. This has resulted in widespread rate-cutting and has exacerbated the financial difficulties in the industry.

The Secretary's inability to foreclose upon the numerous defaulted vessels currently under bankruptcy stays has contributed to the virtual depletion of the Fund, which again will force

borrowing from Treasury in order to continue operating the Program. We are in the process of recommending that Congress amend section 1110 of the Bankruptcy Code to permit us to foreclose on defaulted Title XI vessels.

#### Conclusion

In conclusion, Mr. Chairman, the Title XI Program is going through some difficult times. We have taken steps to tighten the criteria for making loan guarantees and advances that should over time improve the quality of the Title XI portfolio. We need Congress' help in changing the bankruptcy laws so that we can begin to liquidate our collateral and mitigate the need to borrow from Treasury.

There will undoubtedly be additional defaults in the Title XI program, primarily in the inland and offshore industry. I would expect that with continued consolidation and merger of assets between the remaining operators, the level of defaults will be minimal after the next 18 months, but there could be considerable defaults in that interim period. It should be noted that it has been estimated that demands in excess of \$450 million on the fund could occur during the next 18 months. We are continuing to work with shipowners and their principal commercial lenders to try and minimize potential losses and maximize the return on those vessels we have acquired.

For the short run, the non-liquid nature of a sizable amount of our assets will necessitate borrowings from the Treasury. Repayment to the Treasury will come from two primary sources. The first is the ongoing revenues from fees and loan repayments which should approximate \$50 million annually. The second source is the proceeds from the sale of defaulted equipment. Unfortunately, the timing of this second source of revenue is uncertain in many cases as the result of bankruptcy filings by the defaulting shipowners.

If the pre-1978 bankruptcy law were still in effect today, we would be able to quickly liquidate these assets, thus greatly diminishing the need to borrow from the Treasury. While a change in the bankruptcy law will not of course solve the industry problems, in addition to the direct benefits to be realized by the Title XI Program, it would eliminate unfair competition to the shipowners that continue to pay their own way and reduce the possibility of their defaulting on their Title XI debt.

Mr. Chairman, that concludes my prepared statement. I will be pleased to answer any questions that you or the Members of the Subcommittee may have.

APPENDIX A

<u>Vessel Type</u>	<u>No. of Vessels</u>	<u>Outstanding Title XI as of 6-25-85 \$ billion</u>
Tankers	70	\$ 1.9
Cargo Vessels	126	1.0
LNG	14	1.0
Bulk Carriers	24	.4
Drill Rigs/Drill Ships	78	.8
Offshore Service Vessels	496	1.0
Inland Tugs and Barges	3,217	.6
Lighters	1,975	*
Miscellaneous	24	.2

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\* less than \$50 million